Planner Redwood Asset Management

MONTHLY COMMENTARY

FEBRUARY 2014

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Introduction

What does the leap and shake music of Carnival, the political crisis in the Ukraine and the national GDP (the Brazilian 2013 GDP) have in common? Possibly not much, but they have all shaken things up a lot in the last few days.

The official 2013 GDP, although far below the figure promised, when compared with market expectations (and ours!) was much better than forecast. The 2.3% growth is not a figure to celebrate, but is sufficient to create a “Mona Lisa smile”… in the sense that we “dodged the bullet”… have we?

In the international scene, the stage was taken by the political crisis in the Ukraine, already having a ripple effect, as itis one of the worst potential crises of Europe in the last few years. Unsurprisingly, the response of various countries was immediate and the threats and economic sanctions (by diplomatic means) had some effect. Other international situations also had some effect on the business world, such as the speech of the new Chair of the FED (Central Bank of the USA) Janet Yellen, with the new “controversial figures” of the American economy; the return of the discussion/challenges of the Euro (which were considered buried); China’s economic growth and so on.

On the domestic front, the month was not less emotional. We had blackouts and doubts as to an eventual shortage of energy. Groups of large energy consumers, together with the Government, are mapping out the real risks of rationing. In addition, the new fiscal target for 2014 (1.9% of the GDP) was published. However, the figures for the beginning of the year do not seem to align with the target. If the weak fiscal numbers disappoint, worse is the potential loss of the Brazilian credit rating, because this is an essential component of the study made by rating agencies.

As to the leap and shake music, it had a fundamental part in increasing happiness and joy in a good part of the Brazilian population: and this is very important.

With all this excitement, the Treasuries of the USA ended the month at 2.66% and the S&P changed 4.31%. The NIKKEI closed at a negative 0.49%, the DAX at 4.14% and the FTSE at 5.27%. In Brazil, the Ibovespa ended the month at a negative 1.14% and the IBrX at a negative 0.32%. The high for the DIF15 was 11.74% and for the DIF17 13.09%. The NTN-B 2050 ended the month at 6.67% and the Dollar closed at a quote of BRL 2.3334.

Economic Activity I

The British economist Sir John Richard Nicholas Stone received the Nobel Prize for Economics in 1984 for his various studies involving National Accounts and a new accounting format/model for economic activity: GDP. After numerous critics and various adjustments over the years, the methodology is widely accepted in all countries. However, is GDP really the best indicator of the wealth of a nation? It seems this is not so and, therefore, other indicators have been developed and accepted as an alternative (or complementary) to GDP. For example, there is the HDI (Human Development Index). This is an index that measures Social Health (the idea of well being) and Social Balance (quality of services and production of companies in terms of the environment and social effects). In any case, the supremacy of the GDP is uncontestable, even if it "...counts air pollution and cigarette advertising… it measures everything in short, except that which makes life worthwhile…" (Extract from a speech given by Robert Kennedy, Kansas, 1968)

It is nothing trivial, but it seems that the real reason for development (and not only growth) is the search for the well being of humanity...in other words "happiness". Therefore, happiness and economics must walk hand in hand. In this way, a "new concept" has been presented: the Gross National Happiness Index (GNH), defended by no less than Jeffrey Sachs, specialist in development and Special Advisor to the United Nations. GDP and GNH differ in the emphasis given to growth and economic development. In the latter we include not only economic development, but also social, environmental, humanity, technology, etc…but so things begin. As "perfect is the enemy of the good", let us be satisfied with what we have thanks to Sir Richard Stone because, in fact, we do not have to abandon his methodology. In fact, altogether, the relationship between GDP (in particular GDP per capita) and wellbeing is not spurious. We need only analyze the wealthier countries.

Therefore, a GDP growth of 2.3% is far from what we can, and need, to do to have a decent GNH. The change in the political set-up, a new fiscal policy and improvement in public politics are mandatory. Until then, the leap and shake will help us be happier.

Economic Activity II – Details of the GDP (until the next revision)

In an evaluation of the sectors having the most growth, the ones that stand out are agriculture (7.0%) and information services (5.3%), which is a sector classified as modern, but relatively small and with no relevant link to the production stream. The sectors of the economy considered more dynamic did not present such a satisfactory growth (manufacturing 1.9%, mining 2.8%). The Trade sector, in its turn, increased 2.5%, demonstrating that our momentum based on a strategy of consumer expansion is actually slowing. The increase in production in construction (1.9%) was also weak and lower than previous years. There was no change in the share of manufacturing in the consolidated GDP, it remains very low (14.6%), nor where there any change in services (69.8%).

The news is “more or less” with investment rate, which increased from 19.7% of GDP in 2012 to 20.5% last year. Although this share is not substantial, it is the second highest since 1996 (lower only than 2011, when it reached 20.7%) and has been growing, albeit slowly, over the last 12 months. As the share of consumption of families and Government in the GDP remained constant, even if at a high level, we note there was a change in a component of demand (Capital Costs), which could have boosted growth. The devaluation of the Real and Government expenses could also have help in this process: production of electricity, gas and urban infrastructure increased 2.9% in 2013.

The bad news is that, within the demand components, what increased most were imports; and at a high rate. While investments increased 6.3% during the year, imports increased 8.4%. A part of these imports are responsible for the increased productivity, but a growing part of our demand for capital and consumer goods is being supplied by imported products. This would not be a problem if our exports were to grow at a reasonable rate (they increased only 2.5%). Therefore, an important point for the consistent yield on investments is the migration of internal demand to foreign countries, seeing as how foreign savings, as translated in the balance of current transactions, increased 2.9% to 4.1% of GDP between 2012 and 013, while domestic savings decreased. Therefore, it is difficult to hear the Minister talking about growth “of quality”, when the numbers confirm the economic failure of a policy based on encouraging consumption and giving tax incentives to specifically selected sectors.

Fiscal Policy

Finally, the fiscal target was announced: 1.9% of GDP for this year and a block on BRL 44b on the Union's expenses. So far, the measure has been well received, because the figure is not preposterous, in some form it could maintain the Debt/GDP ratio and, given it is the beginning of the year, a vote of confidence was given to this commitment by the Government – particularly considering the long period of loss in credibility of the Fiscal Policy. However, confidence is short-lived, it is necessary to demonstrate that this commitment is meant: because against facts there are no arguments. This is true, the results of January have been published and, despite being early days, the figures do not align with Government statements or target. January's surplus decreased 50.7% YoY and 10.4% MoM. At the same time, Central Government expenses increased 19.5%, with revenue increasing 6.6% YoY. Another method for analysis is the accumulated 12 months. In this the reported primary surplus of the Central Government is equivalent to 1.3% of GDP, below the target of 1.55% of GDP published in the Government's financial Budget.

The consolidated primary surplus of the public sector, which includes Federal administration, state and municipal government and state owned companies, was BRL 19.921b in January, with BRL 12.549b of the Central Government: National Treasury, Central Bank and Social Security. The states and municipalities saved BRL 7.241b (result of the Cash Transfer Programs, which will not recur). State owned companies had a primary surplus of BRL 131m in January.

At present, for this Government, with its composition and "modus operandi", the vote of confidence is a patch on the structure of credibility. The results listed above, especially the atypical growth in expenses, gives us as much confidence as a bull in a china shop – in other words, this pattern of increases in expenses seems to confirm the perception that the expenses which should have been paid in Dec. 13 were postponed for this year: for there to be a surplus in 2013. More creative accounting? We hope not! In any case, confidence comes with caution...that is how the market functions: one eye on the cat and another on the fish.

Attention Government!

International Scenario

The crisis in Ukraine was definitely one of the highlights of the month, given its potential to upset things in Europe, with a ripple effect on the world. It is not surprising, therefore, that representatives of all the more wealthy countries moved fast to minimize a risk of greater chaos. For the moment, this seems to have worked; tensions have eased. However, for different reasons, Europe as a whole is not very well. In various segments; social, economic and political, it seems, at the best hypothesis that several countries are balancing on an unstable edge. Another potential crisis is the return of the debate on keeping the EURO as a common currency. With the worst of the crisis seemingly over (at least for the leaders of Germany and France), many executives, economists and politicians advocate that the currency cannot survive the next turbulence, as few reforms were carried out. The possible fragmentation of the Euro Zone is advocated by economists, who do not believe Germany and France will be able to find a common ground to effect changes in the institutions of the European Union and increase integration to reduce the weak points of the currency; including the absence of a continental Budget or a union of Banks. In fact, it needs to organize its economy and then concentrate on the rest (first things first!). Therefore, the release of the Euro Zone unemployment rate for January was a relief, as it remained stable at 12%. In addition, the annual inflation index was unaltered, reducing pressure on the Central Bank of Europe to take precautionary measures to sustain the financial system. The Block’s composite PMI, which includes the industrial and services sectors, increased to 53.3 in February, from 52.9 in January, reaching the highest level in 32 months. Good news.

In China, we have more of the same. The GDP target was announced at 7.5%, inflation at 3.5% and the increase in Monetary Base (M2) at 13%: all the same as last year. The Chinese PMI of the services sector (official) increased to 55.0 in February, against 53.4 in January and the services sector (HSBC) increased to 51.0 in February, against 50.7 in January. Despite this, the compound Chinese PMI, as measured by the HSBC, dropped to 49.8 in February, from 50.8 in January. Numbers always too complicated to accept and difficult to use.

As to the engine of the world, the USA, weak data reported in the Beige Book indicate that the American economy expanded at a “modest to moderate” rate. This was blamed on the harsh winter, which hindered a more heated growth. In any case, we will continue betting on strong growth (approximately 3%) and a continued reduction in incentives – perhaps with higher interest rates in 2014.

Interest Rates

As the BACEN is not only the guardian of the currency, some variables insist on disrupting the ideal of what the Monetary Policy should be.

Imagine the conflict for the BACEN conscience: ...economic activity is a little better, unemployment and income is reasonably in line...the rate is at equilibrium! Enough, the SELIC is at a good level....but inflation is perilously high and the Fiscal Policy looks like it will not help much! Cripes! We had better increase it a little bit (maybe 0.25%)...but this is an election year! Right, we do not have such autonomy...the rate is adequate. However, our models, so well developed and tested, as well as the market and experts, say the rate should be increased again! Patience, we will increase the interest rate, if necessary, in 2015!

Summary of the opera: we analyze what the COPOM will do and not what it should do (we repeat this as a mantra in our scenario meetings), then we structure our models. The next meetings of the COPOM will show if what it does matches what it should do. We adjust our investment models dynamically/accordingly.

Foreign Exchange

Although the volatility of emerging markets tends to increase, it is unlikely that the situation will evolve to a systemic crisis. Well before this, there are further opportunities “both on the debt and currency front” in Brazil, India and other countries. BACEN has acted, in so far as it can and is set up for, in ways that seem to it to result in adequate quotes. It intervenes, when necessary, only for extraordinary auctions. The idea is to control, with the minimum amount of interference, the range and volatility of the Real against the Dollar. An increase in the value of the Dollar has an almost immediate impact on our inflation levels, which then “messes up” the Monetary Policy. Despite our vulnerability, especially towards foreign markets, we maintain our projection (long-term prospect) for 2014 with the Dollar quoted at between BRL 2.30 and BRL 2.40. For a stress scenario, but within a time horizon perspective and other unalterable macro variables, we preview a quote of BRL 2.60.

At the end of February, the US Dollar was down 3.83%, with the highest quote at BRL 2.4238.

Stock Market

The Ibovespa, once again, had a negative month, dropping 1.14% and bringing the accumulated for the year to a negative 8.57%, more than half the total change of 2013 (-15.5%). Well, there is no sense whatsoever in saying we are setting the scene, because there is no pleasure to be taken in the problems of others, which incidentally is also our problem, to the extent that the hedging (protection for the Fund's investments) do not cover 100% of the portfolio and the correlation of assets is not perfect with the Futures Index of the Ibovespa. The sad thing is that the Ibovespa may drop even further. Fundamentally, nothing essential has changed, leaving us with our distressing inadequacies, misfits and vulnerabilities exposed… tough times. Albert Einstein used to say how impressed he was at seeing his peers always doing something in the same way and expecting a different outcome.

In our case it seems even worse, for there is the team of "the incentive" (notably those so called "development economist"), whose practices are strongly contrary to the perceptions of the market – as if the "market" were the bogeyman and tormentor of the less fortunate. We are like the citizen at the brink of a cliff and someone gives us the incentive to take a step onto the path...or perhaps we are already dropping and expecting a safety net (but for now, all is well). We need to recognize that our way is wrong...that our household chores are waiting and at the limit; and if they are, it is because the ones responsible do not know how to do do them, or even acknowledge they exist. The captain of the team needs to make his presence felt, as most fans want to win the game.

Although there is no doubt that a start of change is in our hands, we cannot forget that external factors will cause us much damage. In fact, they already have, such as the ending of the American economic incentives (QE) and the deceleration of the Chinese economy.

In any case, if our adjustments of the domestic issues propel us to a strong, sustainable growth, perhaps some industries may already be reaching the limit/level that makes them interesting in the long term. It is at this point that we enter, opportunism translated into monitoring, evaluating and investing in a reasonable way.

Hopefully, this drop in the Ibovespa is a technical correction and we are close to the lowest level. Perhaps the drop will not last but, instead, lead to a more sustainable recovery. This would be our safety net.

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